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Canadian Income Tax Law: Cases, Text, and Materials

Volume I

David G. Duff
Faculty of Law
University of Toronto
2000

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Part I

Introduction

The *Income Tax Act*, R.S.C. 1985, c. 1 (as amended) is a daunting document. At the time of writing, the most recent version of the *Stikeman's Act*, 29th edn. (2000), including historical references and various annotations, runs for 1,819 pages. Including regulations and other related statutes and treaties, the published text exceeds 2,600 pages. The Act itself consists of thirty-five "parts", numerous "divisions", various "subdivisions", and a multitude of sections, subsections, paragraphs, subparagraphs, clauses, sub-clauses, and even a few sub-sub-clauses!

At first, this length and complexity suggest incoherence. Indeed, with the constant amendments to the Act since its predecessor was introduced in 1917, it might be argued that the Act lacks any coherent structure or purpose and comprises nothing more than a series of relatively arbitrary rules adopted in response to unforeseen circumstances and prevailing political sentiments. There is, no doubt, some truth to this picture. One would be hard-pressed to describe the evolution of the Act and the process of statutory amendment as the direct and logical unfolding of a single all-embracing idea. Nonetheless, as a product of human reason, it is also arguable that the *Income Tax Act*, like much of the common law, contains a form of "immanent" rationality – a structure and purpose embodied in the various provisions of the text that gives it a coherent meaning accessible to the determined interpreter. It is this understanding of the structure and purpose of the *Income Tax Act* that this casebook is intended to encourage.

In order to achieve this understanding, however, one cannot simply read the provisions of the Act from page 1 to page 1,819, section 1 to 260. The text of the Act is important, indeed crucial, but the text alone – especially if one refers only the most recent version of the Act – is grossly incomplete. First, the text itself is the product of its history and takes it meaning from this history as well as its current language. Second, the text, like all law, has meaning only insofar as it applies to concrete facts; consequently, the text derives its meaning as much from the cases in which it is applied as from the otherwise lifeless words in which it is framed. Indeed, to the extent that statutory amendments reflect a legislative response to judicial decisions, the very words of the Act are themselves a product of an ongoing conversation between the text and the facts. Finally, the text takes its meaning from its irreducible purpose – to levy an income tax. To the extent that an income tax necessarily has a particular form, the Act itself must embody this form in its various provisions.

Chapters 1 to 3 are intended to establish the necessary foundations on which an understanding of the *Income Tax Act* may be based. Chapter 1 contains an introduction to the Canadian income tax, reviewing its history and basic structure as embodied in the provisions of the Act. Chapter 2 is devoted to statutory interpretation, reviewing the various factors which courts may consider in order to determine the meaning of a statutory provision, alternative doctrines which Canadian courts have employed in order to interpret the *Income Tax Act*, and specific sources to which Canadian courts refer for this purpose. Chapter 3 examines judicial and statutory approaches to tax avoidance, which play a central role in the application of the Act to specific facts.

Chapter 1
Introduction to the Income Tax

A. Introduction

In order understand the *Income Tax Act*, it is helpful to begin by considering the role and history of the income tax in Canada, and the basic structure of the tax which this statute is designed to collect. This chapter provides an introduction to the Canadian income tax by reviewing its role and history as well as its basic structure.

B. Role and History of the Income Tax

Although taxes, tithes, or tributes of one form or another have been collected in most societies throughout the course of human civilization, broad-based income taxes like the federal income tax are a relatively recent development, associated with the formation of modern nation states, the emergence of modern market economies, and the increased social and economic role of modern governments. In order to appreciate the role and history of the income tax in Canada, therefore, it is useful to begin by reviewing the economic purposes of modern governments and the various methods by which governments can obtain revenues to finance these purposes.

1. Economic Purposes of Modern Government

Within a modern market economy, in which voluntary exchanges play a central role in the allocation and distribution of economic resources, at least four economic purposes may be attributed to the public sector.[1]

First, since private markets do not automatically ensure the most efficient allocation of economic resources, modern governments have an important role to play to address so-called "market failures". To the extent that certain goods or services (e.g., national defence, or research and development) provide benefits which cannot be easily restricted to those willing to pay for the relevant good or service, for example, economic theory suggests that private markets will undersupply the good or service since "free riders" can benefit from its provision without contributing to its cost. Alternatively,

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[1] For a useful introduction to these "fiscal functions" see Richard A. Musgrave, Peggy B. Musgrave, and Richard M. Bird, *Public Finance in Theory and Practice*, 1st Cdn. ed. (Toronto: McGraw-Hill Ryerson, 1987).

Chapter 2
Introduction to Statutory Interpretation

A. Introduction

As the concept of "income" discussed in Chapter 1 suggests, tax law depends critically on the interpretation of words. In *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955), Chief Justice Warren stated that the U.S. Supreme Court had given a "liberal construction" to the "broad phraseology" of the basic charging section in of the U.S. income tax "in recognition of the intention of Congress to tax all gains except those specifically exempted." In the United Kingdom and Canada, however, the courts generally adopted a much stricter approach to the interpretation of taxing statutes, according to which statutory language was to be construed literally and ambiguities in taxing provisions were to be resolved in the taxpayer's favour.[1] As a result, it followed, the language of the statute was not extended to items not specifically enumerated in the Act.

More recently, however, Canadian courts have broken with this tradition, adopting a more expansive approach to statutory interpretation based less on a literal reading of statutory provisions and more on the objects and intentions pursued through the statutory text. In *Stubart Investments Limited* v. *The Queen*, [1984] C.T.C. 294, 84 D.T.C. 6305 (S.C.C.), for example, the Supreme Court of Canada affirmed the "modern rule" set out in E.A. Driedger's *Construction of Statutes*, according to which "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament."[2] In subsequent decisions, the Federal Court of Appeal has described this "modern rule" as a "words-in-total-context approach".[3]

---

[1] Ambiguities in provisions setting out deductions or exemptions, on the other hand, were to be resolved against the taxpayer. Strict construction is examined later in this chapter in section C.1.

[2] E.A. Driedger, *Construction of Statutes*, 2d ed. (Toronto: Butterworths, 1983) at 87, cited in *Subart*, *supra* at 316 (C.T.C.).

[3] See, e.g., *Harris Steel Group Inc.* v. *M.N.R.*, [1985] 1 C.T.C. 181, 85 D.T.C. 5140 (F.C.A.); *Lor-Wes Contracting* v. *The Queen*, [1985] 2 C.T.C. 79, 85 D.T.C. 5310 (F.C.A.); *Vaillancourt* v. *The Queen*, [1991] 2 C.T.C. 42, 91 D.T.C. 5352 (F.C.A.); *British Columbia Telephone Company* v. *The Queen*, [1992] 1 C.T.C. 26, 92 D.T.C. 6129 (F.C.A.); *The Queen* v. *Old HW-GW Limited*, [1993] 1 C.T.C. 363, 93 D.T.C. 5199 (F.C.A.); *The Queen* v. *Kayelle Management (Yukon) Inc.*, [1994] 1 C.T.C. 271, 94 D.T.C. 6116 (F.C.A); *Hawboldt Hydraulics (Canada) Inc. (Trustee of)* v. *Canada*, [1994] 2 C.T.C. 336, 94 D.T.C. 6541 (F.C.A.); *Tonn* v. *The Queen*, [1996] 1 C.T.C. 205, 96 D.T.C. 6001 (F.C.A.); *Shaklee Canada Inc.* v. *M.N.R.*, [1996] 1 C.T.C. 180 (F.C.A.); *Shell Canada* v. *M.N.R.*, [1998] 2 C.T.C. 207 (F.C.A.); and *The Queen* v. *Brelco Drilling Ltd.*, [1999] 3 C.T.C. 95, 99 D.T.C. 5253 (F.C.A.). The words-in-total-context approach is examined later in this chapter in section C.4.

Since *Stubart*, however, the Supreme Court of Canada has oscillated in its preferred approach to the interpretation of tax statutes.[4] While some decisions favour a "purposive" or "teleological" approach according to which courts should "first ... determine the purpose of the legislation" and apply a strict or liberal approach to the provision "depending on the purpose underlying it",[5] others affirm a "plain meaning rule" according to which the provisions of a tax statute "must be applied regardless of [their] object or purpose" whenever they are "couched in specific language that admits of no doubt or ambiguity in [their] application to the facts".[6] Yet other decisions employ a words-in-total-context approach by reading the words of the relevant statutory provision in light of "the scheme of the Act, the object of the Act, and the intention of Parliament."[7] At the same time, the Court often considers the consequences of alternative interpretations in order to arrive at a preferred meaning.[8]

This chapter provides an introduction to the interpretation of the *Income Tax Act*, looking at various factors which courts may consider in order to determine the meaning of a statutory provision, alternative doctrines which Canadian courts have employed in order to interpret the *Income Tax Act*, and specific sources to which Canadian courts refer for this purpose. Section B reviews the different interpretive elements or considerations identified by Driedger and others who have written on the subject of statutory interpretation: the words of the statute, the context in which these words are to be read, the scheme of the Act, statutory purposes, legislative intentions, and the consequences of alternative interpretations.[9] Section C examines the leading interpretive doctrines which Canadian courts have employed to interpret the *Income Tax Act* (strict construction, purposive or teleological interpretation, the plain meaning rule, and the words-in-total context approach) as well as the more pragmatic approach advocated in recent scholarship on statutory interpretation.[10] Section D reviews the specific sources to which Canadian courts refer in order to interpret the *Income Tax Act*.

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[4] For a review of this jurisprudence, see David G. Duff, "Interpreting the *Income Tax Act* – Part 1: Interpretive Doctrines" (1999), 47 *Can. Tax J.* 464.

[5] *Corporation Notre-Dame de Bons-Secours* v. *Communaute Urbaine de Quebec et al.*, [1995] 1 C.T.C. 241, 95 D.T.C. 5017 (S.C.C.) at 250, 252 (C.T.C.); 5022, 5023 (D.T.C.). For other decisions in which the Supreme Court of Canada has employed a purposive or teleological approach to the interpretation of the *Income Tax Act*, see *The Queen* v. *Bronfman Trust*, [1987] 1 C.T.C. 117, 87 D.T.C. 5059 (S.C.C.) [hereafter *Bronfman Trust*]; *The Queen* v. *McClurg*, [1991] 1 C.T.C. 169, 91 D.T.C. 5001 (S.C.C.) [hereafter *McClurg*]; and *Neuman* v. *The Queen*, [1998] 3 C.T.C. 117, 98 D.T.C. 6297 (S.C.C.) [hereafter *Neuman*]. The purposive approach to the interpretation of tax statutes is examined later in this chapter in section C.2.

[6] Peter W. Hogg and Joanne E. Magee, *Principles of Canadian Income Tax Law*, (Scarborough, Ont.: Carswell, 1995) at 454, cited with approval in *Friesen* v. *The Queen*, [1995] 2 C.T.C. 369, 95 D.T.C. 5551 (S.C.C.) at 373 (C.T.C.) [hereafter *Friesen*]. For other decisions adopting a plain meaning approach, see *Antosko et al.* v. *The Queen*, [1994] 2 C.T.C. 25, 94 D.T.C. 6314 (S.C.C.) [hereafter *Antosko*]; and *Duha Printers (Western) Ltd.* v. *The Queen*, [1998] 3 C.T.C. 303, 98 D.T.C. 6334 (S.C.C.). Interestingly, Professors Hogg and Magee have backed away from this plain meaning approach in the second and third volumes of the *Principles* book. The plain meaning rule is examined later in this chapter in section C.3.

[7] See, e.g., *The Queen* v. *Golden et. al.*, [1986] 1 C.T.C. 274, 86 D.T.C. 6138 (S.C.C.) [hereafter *Golden*]; *Symes* v. *The Queen*, [1994] 1 C.T.C. 40, 94 D.T.C. 6001 (S.C.C.) [hereafter *Symes*]; *The Queen* v. *Province of Alberta Treasury Branches et. al.*, [1996] 1 C.T.C. 395, 96 D.T.C. 6245 (S.C.C.); and *Will-Kare Paving & Contracting Ltd.* v. *Canada*, [2000] CarswellOnt 2456 (S.C.C.).

[8] See, e.g., *Bronfman Trust*, *supra* note 5; *McClurg*, *supra* note 5; *Antosko*, *supra* note 6; *Friesen*, *supra* note 6; and *Neuman*, *supra* note 5. For a brief discussion of consequential analysis as an interpretive element in income tax cases, see David G. Duff, "Interpreting the *Income Tax Act* – Part 2: Toward a Pragmatic Approach" (1999), 47 *Can. Tax J.* 741 at 788-92. The role of consequential analysis in statutory interpretation is examined later in this chapter in section B.6.

B. Interpretive Considerations

In the passage from Driedger's *Construction of Statutes*, five factors are identified as relevant to the interpretation of a statutory provision: the words of the statute, the context in which these words are to be read, the scheme of the statute, the object of the statute, and the intentions of the legislature. In addition to these five factors, courts frequently consider the consequences of alternative interpretations as a further element in the interpretive process. This section reviews each of these considerations and their role in statutory interpretation.

1. Words

In order to interpret a statutory text, one must a text to interpret. As the starting point for statutory interpretation, therefore, it makes sense to look at the words of the statutory text. Indeed, attention to the words of the statute is a basic tenet of statutory interpretation, constraining judicial discretion and reflecting widely-held values associated with legislative supremacy and the rule of law. As William Eskridge and Philip Frickey explain:

> Formally, all that is enacted into law is the statutory text, and at the very least legislative supremacy means that an interpreter must be attentive to the text. Functionally, citizens and lawmakers will rely on the apparent meaning of statutory texts. Textual primacy can also be a useful concrete limit on judicial power.[11]

Not surprisingly, therefore, Driedger's "modern rule" begins with the words of the Act.

Words, however, do not speak for themselves – at least not with fixed and certain meanings of universal application. On the contrary, as any dictionary illustrates, words

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[9] For more thorough treatments of these interpretive considerations, see Ruth Sullivan, *Driedger on the Construction of Statutes*, 3d ed. (Markham, Ont.: Butterworths, 1994); and Ruth Sullivan, *Statutory Interpretation*, (Concord, Ont.: Irwin Law, 1997).

[10] See, e.g., Duff, "Interpreting the *Income Tax Act* – Part 2" *supra* note 8 at 787-97; and Ruth Sullivan, "Statutory Interpretation in the Supreme Court of Canada" (1998-99), 30 *Ottawa L. Rev.* 175.

[11] William Eskridge Jr. and Philip Frickey, "Statutory Interpretation as Practical Reasoning" (1990), 42 *Stan. L. Rev.* 321 at 354.

Chapter 3
Introduction to Tax Avoidance

A. Introduction

Tax law depends not only on the interpretation of words, but also on the interpretation of facts. To the extent that tax consequences depend on the classification of amounts or transactions as being of one type rather than another, courts are confronted with the often difficult tax of characterizing these amounts and transactions for the purposes of assessing tax. This task is rendered even more challenging by the fact that taxpayers, particularly those who are well-advised regarding the tax consequences of alternative courses of action, may endeavour to arrange their affairs specifically in order to obtain a more favourable tax outcome. Indeed, these arrangements raise yet further interpretive issues about the character of the amounts or transactions to which the *Income Tax Act* ought to apply.

As opposed to tax "evasion", which involves an illegal breach of specific statutory duties such as failing to file a return, or deliberately concealing or falsifying reported information,[1] these legal efforts to order one's affairs to minimize tax are labelled "tax avoidance". As the cases and statutory provisions examined in this chapter illustrate, the challenges posed by such tax avoidance have been a fertile source of judicial analysis and statutory reform. Section B reviews alternative approaches to tax avoidance adopted by the courts in Canada, Great Britain and the United States. Section C considers specific anti-avoidance rules designed to prevent certain kinds of avoidance transactions considered sufficiently unacceptable to require a legislative response. Section D examines the General Anti-Avoidance Rule (GAAR) in section 245, which was enacted in 1988.

B. Judicial Anti-Avoidance Doctrines

The development of judicial doctrines in Canada, Great Britain and the United States reflect widely different attitudes and approaches to taxpayer efforts to avoid or minimize their tax liabilities. Consistent with the doctrine of "liberal construction"

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[1] See sections 238 and 239 of the Act, which make tax evasion a criminal offence. See also sections 162 and 163 which impose civil penalties for various acts and omissions. This casebook does not examine these provisions nor the investigatory powers which the revenue authorities may employ to determine the existence of tax evasion. For a brief summary of criminal prosecutions under the *Income Tax Act*, see Peter W. Hogg and Joanne E. Magee, *Principles of Canadian Income Tax Law*, 2nd edn., (Scarborough: Carswell, 1997) at 24-25.

Chapter 4
Office or Employment

A. Introduction

According to paragraph 3(a), a taxpayer's income for the year includes the taxpayer's income for the year from each "office" and each "employment". The rules governing the computation of a taxpayer's income or loss from an office or employment are found in Subdivision a of Division B of Part I of the Act, comprising sections 5 to 8. Subject to the rules in Part I of the Act, subsection 5(1) defines a taxpayer's income for a taxation year from an office or employment as "the salary, wages and other remuneration, including gratuities, received by the taxpayer in the year." Correspondingly, subsection 5(2) defines a taxpayer's loss for a taxation year from an office or employment as "the amount of the taxpayer's loss, if any, for the taxation year from that source computed by applying, with such modifications as the circumstances require, the provisions of the Act respecting the computation of income from that source." Sections 6 and 7 specify various amounts that must be included in computing a taxpayer's income from an office or employment, and section 8 sets out specific amounts that may be deducted in computing a taxpayer's income from an office or employment.

Because income from an office or employment is computed according to an identical set of rules, the distinction between these two sources is irrelevant for tax purposes. In contrast, two significant tax consequences turn on the distinction between income from an office or employment and income from a business or property. First, the deductions permitted under section 8 in computing a taxpayer's income from an office or employment are much less generous than those available in computing a taxpayer's income from a business or property under Subdivision b.[1] Second, employers are required to withhold and remit income and payroll taxes in respect of amounts paid to employees.[2] As a result, both individuals contracting to provide services to others and persons contracting to obtain services will usually prefer that the source of an amount be characterized as business or property rather than office or employment. For the Revenue authorities, however, characterization as income from an office or employment is typically more advantageous.

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[1] See chapters 8 and 9, *infra*.

[2] See subsection 153(1) of the *Income Tax Act*, sections 68 and 82 of the *Employment Insurance Act*, S.C. 1996, Chap. 23, s. 82, and sections 9 and 21 of the *Canada Pension Plan*, R.S.C. 1985, Chap. C-8. In addition to these federal payroll taxes, a number of provinces levy payroll taxes in respect of amounts paid to employees. See, e.g., *Employer Health Tax Act*, R.S.O. 1990, Chap. E-11, and the *Workplace Safety and Insurance Act*, S.O. 1997, Chap. 16. Under the *Canada Pension Plan* and some provincial payroll tax acts, self-employed individuals are required to make contributions equivalent to the sum of employer and employee contributions which would be payable if an employment relationship did exist.

This chapter considers the characterization of an office and employment as sources of income and the various amounts included in computing a taxpayer's income from these sources. The computation of income or loss from an office or employment is examined in chapter 8.

B. Characterization

For the purposes of the *Income Tax Act*, the terms "office" and "employment" are defined in subsection 248(1) of the Act. An "office" is "the position of an individual entitling the individual to a fixed or ascertainable stipend or remuneration" including:

> . . . a judicial office, the office of a minister of the Crown, the office of a member of the Senate or House of Commons of Canada, a member of a legislative assembly or a member of a legislative or executive council and any other office, the incumbent of which is elected by popular vote or is elected or appointed in a representative capacity and also includes the position of a corporation director. . .

"Employment" is defined as "the position of an individual in the service of some other person (including Her Majesty or a foreign state or sovereign)". Correspondingly, a person holding an employment position is referred to as a "servant" or "employee". The term "employee" is deemed to include "officers" (those persons holding an "office" as defined) and the term "employer" includes the person from whom an officer receives remuneration.

Whether because of the specificity of the statutory definition or the limited number of "offices" within the meaning of the statutory definition, few cases have considered the characterization of an "office" as a source of income or loss. Nonetheless, it has been suggested that an office typically "denotes a subsisting, permanent, substantive position which has an existence independent of the person who fills it, and which goes on and is filled in succession."[3] A mayor, an alderman, and a university professor in his official capacity were found to be officers in one trilogy of cases,[4] whereas a taxpayer appointed to participate as a member of a Royal Commission was found not to have held an office due to the impermanent nature of the commissioner's appointment and the fact that a series of individuals were not appointed to complete the same duties.[5]

In contrast, the distinction between employment and business as sources of income or loss has been and continues to be a subject of considerable litigation, particularly in cases where an individual supplies services to another person. The following sections examine the various tests by which courts distinguish between

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[3] *MacKeen* v. *M.N.R.*, [1967] Tax A.B.C. 374 at 380.

[4] See, respectively, *Badanai* v. *M.N.R.*, 51 D.T.C. 378 (T.A.B.); *Mitchell* v. *M.N.R.*, 51 D.T.C. 380 (T.A.B.); and *Blatz* v. *M.N.R.* 51 D.T.C. 382 (T.A.B.).

[5] See *MacKeen*, *supra* note 3.